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Supreme Court of the United States.

OCTOBER TERM, 1920.

No. 742.

JAMES J. WALSH, United States Collector of Internal Revenue for the District of Connecticut,

Plaintiff in Error.

v.

FREDERICK F. BREWSTER,

Defendant in Error.

WRIT OF ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE DISTRICT OF CONNECTICUT.

BRIEF AND ARGUMENT FOR DEFENDANT IN ERROR.

WILLIAM D. GUTHRIE,
HENRY F. PARMELEE,
GEORGE D. WATROUS,
BARRY MOHUN,
Of counsel for Defendant in Error.

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Defendant in Error.

WRIT OF ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE DISTRICT OF CONNECTICUT.

BRIEF FOR THE DEFENDANT IN ERROR.

This is a writ of error to the District Court of the United States for the District of Connecticut to review a judgment for the defendant in error (the plaintiff below) rendered December 16th, 1920. The case was tried, without a jury, on the pleadings, and on a stipulated statement of facts. The court below filed an opinion (Record p. 18.)

STATEMENT.

The Record presents the constitutional question whether the increase in value of corporate bonds, originally acquired and held for investment, is taxable as income under the Sixteenth Amendment to the Constitution of the United States, when such bonds are sold. The case differs from Merchant's Loan and Trust Company *v.* Smietanka, No. 608, of the present

term, in that the defendant in error (the plaintiff below) was a natural person who owned the bonds in question directly for his own benefit, and not in trust. It is stipulated, and found by the court below that he was in no way "engaged in the business of buying or selling stocks and bonds, otherwise than occasionally making purchases of stocks and bonds for investment purposes, and occasionally making sales of such stocks and bonds for the purpose of changing the character of his investments." (Record p. 19).

The facts are so fully stated in the opinion of the court below, that we state them here concisely and without detail, as follows:

(a) In 1899, the defendant in error acquired as an investment, $191,000 in face value of bonds of International Navigation Company, a domestic corporation for $191,000. On March 1, 1913, based on market quotations at 79½, the market value of these bonds was $151,845. He continuously retained these bonds as an investment from the date of their acquisition, until he sold them during the year 1916, for their face value, $191,000, their cost in 1899. Based on this transaction a tax was assessed on $39,155.00 as income, this being the difference between the market value of the bonds on March 1, 1913, and the sum received therefor when sold.

(b) In 1906 the defendant in error acquired as an investment $257,000.00 in face value of bonds of International Mercantile Marine Company, as the court below finds, at a cost of $231,300.00. On March 1, 1913, based on market quotations at 64, the market value of these bonds was $164,480.00. These bonds were also retained by the defendant in error as an in-

vestment from 1906 until he sold them during the year 1916 in part at 107⅜ and in part at 107½ for the sum of $276,150.00. On this transaction a tax was assessed on $111,670.00 as income, this representing the difference between the March 1, 1913, market value and the sum received.

(c) The defendant in error received during the year 1916 a stock dividend declared against a surplus, in part earned after March 1, 1913, from Standard Oil Company of California. A tax was assessed upon this dividend stock, which defendant in error had not sold, as constituting income to the amount of $12,019.41. This is the identical stock dividend passed upon by this court in *Eisner v. Macomber*, 252 U. S. 189.

The total amount of tax based upon these three transactions, amounting to $17,756.79, was paid to the plaintiff in error as Collector of Internal Revenue, in the following manner: the sum of $67.66 constituted a conceded over-payment of normal tax which was due to the defendant in error; the balance, $17,689.13, was paid to the plaintiff in error under protest, and an appeal taken to the Commissioner of Internal Revenue, which was denied and suit was thereafter brought. In the court below, the plaintiff below (the defendant in error), claimed that in so far as the Income Tax Act of 1916 purported to tax such investment increment as income, it was unconstitutional and that in any event the act should not be so construed as to tax as income anything in excess of the difference between cost and sale price of investments. The court below sustained the defendant in error on the constitutional question and since the defendant in error had realized a sum in

excess of cost price, the question of statutory construction became immaterial, and the court below did not pass upon it.

The Income Tax Law of 1916 (39 Stat. 756, Ch. 463, Part I) provides, in so far as applicable:

> Section 1 (a). "That there shall be levied, assessed, collected and paid annually upon the entire net income received in the preceding calendar year from all sources by every individual, a citizen or resident of the United States, a tax of two per centum upon such income; . . . "
>
> (b). "In addition to the income tax imposed by subdivision (a) of this section (herein referred to as the normal tax) there shall be levied, assessed, collected and paid upon the total net income of every individual . . . . . an additional income tax (herein referred to as the additional tax) . . . . . " (Surtax rates omitted.)
>
> "For the purpose of the additional tax there shall be included as income the income derived from dividends on the capital stock or from the net earnings of any corporation . . . . . "
>
> (c). "The foregoing normal and additional tax rates shall apply to the entire net income, except as hereinafter provided, received by every taxable person in the calendar year nineteen hundred and sixteen and in each calendar year thereafter."
>
> Section 2 (a). "That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form

paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever: *Provided*, that the term 'dividends', as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, joint-stock company, association, or insurance company, out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, joint-stock company, association, or insurance company, which stock dividend shall be considered income, to the amount of its cash value."

(c). "For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived."

Section 5. "That in computing net income in the case of a citizen or resident of the United States:

(a). For the purpose of the tax there shall be allowed as deductions:

"*Fourth*. Losses actually sustained during the year, incurred in his business or trade, or arising from fires, storms, shipwreck, or other casualty, and from theft, when such losses are not compensated for by insurance or otherwise:

Provided, That for the purpose of ascertaining the loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such loss sustained;

"*Fifth*. In transactions entered into for profit but not connected with his business or trade, the losses actually sustained therein during the year to an amount not exceeding the profits arising therefrom;....."

SUMMARY OF POINTS.

1. Bonds are property without reference to cost or market value. The bonds themselves are their owner's capital assets, and his capital interest therein is not limited to their cost, or to their value as determined by market quotations on a date fixed by an Act of Congress.

2. Increase in value of property held as investment is not income.

3. The sale of an investment realizing an increase in value does not create, or result in the derivation or receipt of, income.

4. Construed to tax as income any part of the proceeds of the sale of a capital investment, the Income Tax Law of 1916, is to that extent invalid as in conflict with Article I, Section 2, Clause 3, and Article I, Section 9, Clause 4 of the Constitution, being a direct

tax on property, and not coming within the provision of the Sixteenth Amendment.

5. Notwithstanding the construction placed thereon by the Commissioner of Internal Revenue, the Income Tax Law of 1916 does not purport to tax the proceeds of the sale of a capital investment or any part thereof as income.

Argument.

I.

Bonds are Property without Reference to Cost or Market Value. The Bonds themselves are their Owner's Capital Assets, and his Capital Interest therein is not Limited to their Cost, or to their Value as Determined by Market Quotations on a Date Fixed by an Act of Congress.

A bond is more than evidence of an initial investment of a capital sum. It is property itself. It is under seal—a specialty—ownership passes by delivery as in case of any chattel. In itself, it is the investor's property equally with his house, without limitation of its value *as capital* to its cost, or to its market value on March 1, 1913. It is his capital, the thing itself, in its entirety. His house is his capital, used to shelter himself and his family. His bonds are capital, purchased to be held as property, to produce a regular recurrent income to support himself and his family. The house and the bonds are in themselves his capital.

Investment bonds, not their cost or former market value, are capital. Their regular recurrent interest payments, not the fluctuations of market values, are income.

The trader in houses or bonds, on the contrary, has a cash capital. He buys, not a capital asset to provide a home or an income for his own use, but a house, or bond, to be sold at the market; his capital asset in each transaction is the amount of cash capital expended from the working capital of his business, and his income is the difference between his aggregate gains and losses less the expenses of his business, covering the period of the year.

This distinction between transactions of a trader and an investor is recognized in the cases hereinafter cited, and in our own legislation.

The Income Tax Law of 1913 (38 Stats. 167, Ch. 16, Sec. II B), permitted the offset of losses in trade to determine net taxable income, but did not permit an investor to offset realized losses. *Mente v. Eisner*, C.C.A. 2nd Cir. 226 Fed. 161.

The Income Tax Law of 1916 (39 Stats. 759) permitted one, in transactions apart from his business, to offset his losses but only to the amount of his gains in similar transactions.

The distinction is constantly applied in excise taxes applicable only to business.

The defendant in error's bonds, therefore, as long as he retained them, were his property, unaffected by the fluctuations in their market value. As his property, they were capital assets in their entirety on the days he sold them. The value of his capital was the market value of the bonds on the days when sold. Each

sale resulted in a transmutation of capital from bonds to cash to the amount of their exact value on that day.

II.

Increase in Value of Property Held as Investment Is Not Income.

> "Enrichment through increase in value of capital investment is not income in any proper meaning of the term." *Eisner v. Macomber*, 252 U.S. 189, 214-215.
>
> "Mere advance in value in no sense constitutes the gain, profits, or income specified by the statute. It constitutes and can be treated merely as an increase of capital." *Gray v. Darlington*, 15 Wall. 63, 66. Affirmed in *Lynch v. Turrish*, 247 U.S. 221.

III.

The Sale of an Investment Realizing an Increase in Value Does Not Create, or Result in the Derivation or Receipt of, Income.

This question had frequently arisen between beneficiaries of trust funds who were entitled to entire net incomes for life, and trustees and remaindermen, and prior to the adoption of the Sixteenth Amendment, it had been uniformly held that the realized increase in value of investments which were sold, were not income but principal. *Boardman v. Mansfield*, 79 Conn. 634; *Parker v. Johnson*, 37 N. J. Eq. 366; *Outcault v. Appleby*, 36 N.J. Eq. 74, 78; *Smith v. Hooper*, 95 Md. 16;

In re Armitage, (1894) 3 Ch. D. 337; *Whitney v. Phoenix*, 4 Redf. 180; *Matter of Gerry*, 103 N.Y. 445; *Neel's Estate* (No. 2), 207 Pa. St. 446; *Slocum v. Ames*, 19 R.I. 401; *Jordan v. Jordan*, 192 Mass. 337.

In *Stratton's Independence v. Howbert*, 231 U.S. 399, this court plainly recognizes that the mere transmutation of property into cash does not result in taxable income. Speaking by Mr. Justice Pitney (pages 414, 415):

> "It is not correct, from either the theoretical or the practical standpoint, to say that a mining corporation is not engaged in business, but is merely occupied in converting its capital assets from one form into another. *The sale outright of a mining property might be fairly described as a mere conversion of the capital from land into money.* But when a company is digging pits, sinking shafts, tunnelling, drifting, stoping, drilling, blasting, and hoisting ores, it is employing capital and labor in transmuting a part of the realty into personalty, and putting it into marketable form. The very process of mining is, in a sense, equivalent in its results to a manufacturing process." (Italics ours.)

In the case at bar there is nothing but a mere conversion of the capital from bonds into money, the court below having expressly found that the defendant in error was in no way engaged in the business of buying and selling securities, beyond occasionally buying for investment and occasionally selling for the purpose of changing the character of his investments. The facts in the case at bar do not materially differ from the facts in *Gray v. Darlington*, 15 Wall. 63. The applicable statute in that case, the Income Tax Law of 1867,

laid a tax "upon the gains, profits, and income of every person . . . whether derived from any kind of property . . . or from any other source whatever." If the realized advance in value of the bonds in *Gray v. Darlington* was income, manifestly it was taxable. If it was income, it was derived during the year when it was realized, as clearly it was not derived before realization. The question of any distinction in meaning between the word "derived" in the Act of 1867 and "received" in the Act of 1916 may be dismissed. The only question is as to the meaning of the word "incomes" in the Sixteenth Amendment, which is only one of the words included in the definition of the subject of tax in the Act of 1867, that is "gains, profits, and income". If the realized advance in value of investments does not come within the definition of income as used in the Act of 1867, it does not come within the meaning of the word as used in the Sixteenth Amendment.

> "The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits, or income specified by the statute. It constitutes and can be treated merely as increase of capital." *Gray v. Darlington, supra*, at page 66.

In *Lynch v. Turrish*, 247 U.S. 221, 230, the above passage from the opinion by Mr. Justice Field in *Gray v. Darlington* is quoted, and to the quotation the court adds, "This case has not since been questioned or modified."

It so appears that under the decisions of this court, the sale of an investment realizing an increase in value does not create or result in the derivation or the receipt of income. This, of necessity, follows from the unquestionable proposition that the property in investments are the investments themselves whether the investments be lands, chattels, bonds or stocks.

The decisions in this court are in accord with those in the English and Colonial courts which, without exception, hold that the realized advance in value of investment property is not income taxable under acts which tax income without exception. *Assets Co. Ltd., v. Forbes*, 3 Tax Cases 542, 24 Rettie 578; *Scoble v. Secretary of State for India* (1903) A. C. 299, affirming (1903) 1 K. B. 494; *Californian Copper Syndicate, Ltd., v. Harris*, 5 Tax Cases 159; *Taxation Commissioners v. Mooney* (1907) A. C. 342; *Hudson's Bay Co., Ltd., v. Stevens*, 5 Tax Cases 424; *Trebrau (Johore) Rubber Syndicate, Ltd., v. Farmer*, 5 Tax Cases 658; *Commissioner of Taxes v. Melbourne Trust, Ltd.*, (1914) A. C. 1001; *Mooney v. Commissioners* (1905) 3 Commonwealth Law Rep. 221, affirmed (1907) A. C. 342; *Webb v. Australian Deposit & Mortgage Bank, Ltd.*, (1910), 11 Commonwealth Law Reps. 223; *Bohemians Club v. Acting Federal Commissioner of Taxation* (1918) 24 Commonwealth Law Reps. 334; *McLachlan v. Commissioner of Taxes* (1912) South Australian Law Reps. 138; *Shiels v. Commissioner of Taxes* (1912) South Australian Law Reps. 175; *Commissioner of Taxes v. Booysen's Estate, Ltd.*, So. African Law Reps. (1918) App. Div. 576; *In re the All Red Line, Ltd.*, (British Columbia) Westerly Weekly Reports, 1920, Vol. I, p. 1030.

IV.

CONSTRUED TO TAX AS INCOME ANY PART OF THE PROCEEDS OF THE SALE OF A CAPITAL INVESTMENT, THE INCOME TAX LAW OF 1916, IS TO THAT EXTENT INVALID AS IN CONFLICT WITH ARTICLE I, SECTION 2, CLAUSE 3, AND ARTICLE I, SECTION 9, CLAUSE 4 OF THE CONSTITUTION, BEING A DIRECT TAX ON PROPERTY, AND NOT COMING WITHIN THE PROVISION OF THE SIXTEENTH AMENDMENT.

The scope of the Sixteenth Amendment has been definitely determined by this court.

> "In order, therefore, that the clauses cited from Article I of the Constitution may have proper force and effect, save only as modified by the Amendment, and that the latter also may have proper effect, it becomes essential to distinguish between what is and what is not 'income,' as the term is there used; and to apply the distinction as cases arise, according to truth and substance, without regard to form. Congress cannot by any definition it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised." *Eisner v. Macomber*, 252 U. S. 189, 206.
>
> "Thus the genesis and words of the Amendment unite in showing that it does not extend the taxing power to new or excepted subjects, but merely removes all occasion otherwise existing for an apportionment among the States of taxes laid on income, whether derived from

> one source or another. And we have so held in other cases." *Evans v. Gore*, 253 U. S. 245, 261-262.

In order then to preserve the proper force and effect of the clauses in Article I, relative to direct taxation, the Sixteenth Amendment must not be so construed as to permit the direct taxation of property without apportionment, by including in the definition of the word income, realized capital.

> "The fundamental relation of 'capital' to 'income' has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop; the former depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time. For the present purpose we require only a clear definition of the term 'income,' as used in common speech, in order to determine its meaning in the Amendment; and, having formed also a correct judgment as to the nature of a stock dividend, we shall find it easy to decide the matter at issue." *Eisner v. Macomber, supra*, pages 206–207.

The clear definition of the term "income," as used in common speech at the time of the adoption of the Sixteenth Amendment, certainly did not include any part of the principal value of lands, chattels or investment bonds. The expression "common speech" used by this court does not mean ignorant speech. Furthermore, the amendment was adopted after the meaning of the word income had been well established by the decisions of this court and many state courts which we

have cited, and the decisions of the British courts, uniformly holding that the proceeds of the sale of a capital investment are wholly capital, though sold at an advance over initial cost.

In *Eisner v. Macomber, supra*, in applying the definition adopted in *Stratton's Independence v. Howbert, supra*, and *Doyle v. Mitchell Brothers*, 247 U. S. 179, 185, "income may be defined as the gain derived from capital, from labor, or from both combined," this court added the following explanation (page 207):

> " '*Derived — from — capital*'; — 'the *gain — derived — from — capital*,' etc. Here we have the essential matter; *not* a gain *accruing* to capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value, *proceeding from* the property, *severed from* the capital, however invested or employed, and *coming in*, being '*derived*,' that is, *received* or *drawn by* the recipient (the taxpayer) for his *separate use*, benefit and disposal:—*that* is income derived from property. Nothing else answers the description."

In the case at bar the tax was laid upon "a gain accruing to capital," "a growth or increment of value in the investment." There was not a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital. The tax was laid on the capital itself, the exact equivalent in value of the bonds, no part of which were income.

The court states, *Eisner v. Macomber, supra*, page 213:

> "Yet, without selling, the shareholder, unless possessed of other resources, has not the where-

withal to pay an income tax upon the dividend stock. Nothing could more clearly show that to tax a stock dividend is to tax a capital increase, and not income, than this demonstration that in the nature of things it requires conversion of capital in order to pay the tax."

This is equally applicable to the sale of bonds. They are, without question, capital in their entirety before sold; when sold the proceeds do not exceed the value of such capital. If the holder thereof has no other resources, he must, in order to pay the tax, utilize and thereby diminish his capital.

V.

NOTWITHSTANDING THE CONSTRUCTION PLACED THEREON BY THE COMMISSIONER OF INTERNAL REVENUE, THE INCOME TAX LAW OF 1916 DOES NOT PURPORT TO TAX THE PROCEEDS OF THE SALE OF A CAPITAL INVESTMENT OR ANY PART THEREOF AS INCOME.

A tax levied on the entire net income as provided in Section 1 (a) of the Act of 1916, would not apply to any part of the sum received from the sale of an investment, because such sum in its entirety is a realization of capital. If any income were included in such sum it must have been equally included in the property before it was sold. But it is not now open to argument that capital increment is income in the absence of a sale. *Eisner v. Macomber, supra.*

The Government, however, claims that the tax on this increment is justified by Section 2 (a) of the Act of 1916. This section levies no different tax, separate from or in addition to the tax levied in Section 1 (a)

upon "entire net income." It describes but adds nothing to the expression "net income."

Section 2(a) provides that "the net income of a taxable person . . . shall include gains, profits and income derived from . . . trade, commerce or sales or dealings in property." This neither compels nor permits the inclusion of the proceeds of a sale of capital assets, or any part thereof in net income. It can refer only to sales in the usual course of the taxpayer's business, because it is only on such sales that gains, profits or income can be realized.

The sale of a capital asset realizes no more than its capital value. No profit, income, nor gain, can be derived from its sale. The gain derived from increase in value is capital increment, not taxable. That gain, the capital increment, is *not derived from the sale*, and does not come within the Act.

Unless a practical construction by the Treasury Department can effectively enlarge the scope of a statute imposing taxation, there is, in the Act in question, at least a doubt which requires it to be "construed most strongly against the Government, and in favor of the citizen," as held in *Gould v. Gould*, 245 U. S. 151, 153. The construction contended for by the Government, as we have shown, renders the Act invalid in so far as it taxes increase in value of capital investments. As it admits of a contrary and valid construction, the Act should be held not to tax the realization of property values, but only income.

Conclusion.

This case was argued at length, orally and by exhaustive briefs on behalf of both parties, before the

Judge of the District Court, who held the case under advisement and after long and careful consideration filed a comprehensive opinion deciding the case on the constitutional ground in favor of the plaintiff, (the defendant in error here). Under these circumstances, ordinarily, we would feel it due to this court to submit a full discussion of cases cited, and other cases, and an argument of greater length. As certain questions in the case have been presented to the court in other cases recently, and in the brief thereon filed in behalf of the plaintiff in error in the case of *Goodrich v. Edwards*, No. 663, of this term, it seems unnecessary to burden the court with detail which would be, to some extent at least, repetition of the substance of arguments presented in the Goodrich case.

It is respectfully submitted that the judgment of the District Court should be affirmed.

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February, 1921.